

Expanding the Definition of SRF Financial Assistance

The goal of the concept discussed herein is to permit SRFs to be managed more efficiently and provide more funding for SRF-eligible projects. The proposed mechanism for allowing more efficient operation is to authorize SRFs to provide a form of financial assistance to eligible projects that would not require that invested program equity be yield restricted under IRS arbitrage regulations. Without the restrictions, SRF programs could earn more interest and use that money for projects. The perpetuity requirement applicable to SRFs would remain unchanged.

Under EPA's current SRF regulations, a subsidy can be given to a borrower in order to provide a below market interest rate on a loan either made or local debt obligation purchased by the SRF. However, the use of SRF equity to provide a debt service subsidy triggers the federal arbitrage restrictions on the investment of SRF program equity. Efforts to obtain relief from the arbitrage regulations by exempting SRFs from application of the generally applicable arbitrage rules have not been successful thus far.

The proposed alternative is to permit SRF assistance to eligible projects for capital or operating costs. Project eligibility would be determined under the same set of rules as presently exist, so that the kinds of projects eligible for assistance would not change under this new program. For example, an SRF could provide assistance (in an amount equivalent to what would currently be provided as a debt service subsidy) either by funding construction costs or funding an annual operating subsidy for a project that receives a market rate SRF financing. The SRF would still have to be maintained in perpetuity. The effect of the perpetuity requirement is that whatever the form of the financial assistance (i.e., for debt service, capital or operating cost of an eligible project), it would have to be provided from accumulated, current or future earnings on SRF equity.

By combining a guaranty of borrower debt (or a market rate loan from the SRF to the borrower or a purchased local debt obligation) with the provision of capital or operating assistance, there would be no basis under the arbitrage regulations for any yield restriction of SRF money relating to the provision of that assistance. While the Department of the Treasury may have some concerns with this approach, we believe this idea derived from a guaranty approach, creates the possibility of realizing the benefit of arbitrage relief without the need to change existing IRS regulations.

Rather than requiring a change in or exception to IRS regulations, this approach allows SRF assistance to be structured in a way that does not trigger the application of the IRS arbitrage rules. Amendments to CWF and DWF regulations that could be made to implement this concept (with complementary statutory authority) are attached hereto.

No significant change in the administration or supervision of the state SRFs would be required under this approach (although a modest change of interpretation described below would maximize the benefits of the new approach). Also, this would not change the SRF program into a traditional "grant" program since the SRF would still be maintained in

perpetuity. However, small communities, in particular, that may have previously been reluctant to take advantage of the SRF program because of lack of understanding of the benefits of reduced interest rates may be attracted to the idea of operating subsidies (even though the net financial impact would be the same). Thus, this programmatic change may have the collateral benefit of attracting new participants to the SRF program. This would be especially beneficial because a community that participates in the SRF program is subject to conditions that move the community toward improved financial management and full-cost pricing.

Currently SRFs are permitted to provide assistance in an amount (the “Maximum Assistance Amount” or “MAA”) up to the cumulative retained earnings available at any time. (In the case of direct loans, the SRF forgoes earnings by making below-market investments in the form of borrower loans). The decision as to how much of the MAA to apply currently to provide assistance is made by each state. Each state certifies on an annual basis that it has not provided assistance in excess of that amount – i.e., that it is in compliance with the perpetuity requirement. Currently, the portion of the MAA applied to provide assistance is applied to provide an interest subsidy either:

- By paying down a portion of the interest on bonds used to fund a loan to or purchase a debt obligation from the borrower or
- By providing financing to the borrower from SRF equity at a below-market interest rate.

Under the proposed approach, each state SRF would also have the option of applying its accumulated earnings to fund construction or operating costs rather than to provide an interest subsidy. The provision of capital assistance would reduce the amount of SRF financing that the borrower would need for the project. The SRF would also make or guarantee the market-rate SRF financing (a loan or purchased debt obligation) for the balance of the borrower’s construction costs. In the case of operating assistance, the SRF would also make or guarantee financing for the construction costs of the project.

The reason that only 40% to 60% of the benefit of arbitrage relief would be obtained from the provision of capital assistance is that to provide an equivalent amount of capital assistance, at the outset the SRF would need to pay to the borrower an amount equal to the present value of the interest subsidy that is currently being provided. If the present value of the assistance were 40% of the amount of equity allocable to provide the subsidy, then only 60% of the equity would remain to be invested on an unrestricted basis. Hence, only 60% of the benefit of arbitrage relief would be achieved.

The payment of up-front capital assistance could raise a potential question of interpretation of the perpetuity rule. No question is raised to the extent that the capital assistance is funded from previously accumulated earnings. However, to the extent that future earnings on the SRF’s invested capital will be needed to maintain perpetuity, the current application of the rule (which looks only at earnings in hand) may limit the use of this more beneficial approach. This issue could be eliminated by interpreting the perpetuity requirement to allow SRFs to take into account of:

- Expected earnings on existing investments:
 - ▶ Since the SRF had credit exposure to the investment provider for both principal and interest, there is no reason to only consider investment earnings that have already been “earned”.
- Projected earnings on invested equity based on reasonable assumptions made by the SRF:
 - ▶ To maximize its investment earnings, an SRF may want to adopt a more innovative investment strategy than locking up its investments for the full period that it would otherwise have funded loans or purchased obligations. This should be encouraged by authorizing SRFs to make reasonable projections of future earnings on reinvestments of its existing equity.
 - ▶ Under this approach, the projections would be over the entire period for which the SRF has outstanding financial assistance in the form of loans, purchased local debt obligations or guarantees.

Providing operating assistance payable annually for a period equal to what the term of an SRF financing would be, has the benefit of allowing 100% of the SRF’s equity to be invested on an unrestricted basis. So, the full benefit of arbitrage relief would be achieved. Also, the current interpretation of the perpetuity rule would not pose any problem to implementation of this approach. The attached diagrams contrast the cash flows for an SRF providing operating assistance to the cash flows of an SRF that uses the reserve model.

For SRFs that currently use the Reserve Fund approach, there would likely be no federal budgetary impact of the proposal. The amount of borrowing by such SRFs would not change. Also, while they are currently required to invest at a restricted yield, they have not complied with such restriction by investing in SLGS (which benefit the US Treasury) but by investing in other lower yielding investments (from which the US Treasury derives no benefit). Those programs would modify their structures to look more like the General Revenue Bond approach adopted by Connecticut or the Subordinate Bonds approach utilized by New York which would permit unrestricted investment of program equity if financial assistance were provide for either capital costs of operating expenses.

However, if capital assistance or operating assistance were permitted, SRFs in states (a) that have to date made only direct loans (i.e., funded from program equity) or (b) that use a combination of direct financing and bond-funded financing (referred to as the Cash Flow approach), would be likely to convert to an approach in which SRF financing is provided from bond proceeds rather than from equity. This could significantly increase the amount of funding available for clean water and drinking water projects in those states, but it would also increase the amount of their tax-exempt borrowing. So, there

would be budgetary impact relating to the SRFs that use direct loans or the Cash Flow approach. The budgetary impact would be the same as if arbitrage relief were granted.